

Committee Name: **Income Tax Modernization Subcommittee**

Members: **Mr. Keith Davis, Chair**
Sen. David Hoyle, Co-chair
Mr. Randall Kaplan
Mr. John Medlin
Dr. Wilhelmenia Rembert
The Honorable E. Norris Tolson

Staff: **Ms. Cindy Avrette, Staff Attorney**
Ms. Sabra Faires, Senate Tax Counsel
Ms. Cindy Garrison, Committee Clerk
Dr. Roby Sawyers, NC State University
Dr. Dan Schisler, East Carolina University

Meetings: **12-19-06, 1-16-07, 1-22-07, 1-29-07, 2-15-07, 3-5-07**

I. Brief review of the subcommittee's charge

1. Determine whether the overall mix of revenue sources at the state level is appropriate.
2. Review the following taxes to determine whether any changes are needed to align the taxes in accordance with the general tax principles set out below:
 - a. Individual income tax
 - b. Corporate income and *franchise* tax
 - c. Estate and gift taxes
3. Identify ways to broaden the tax base, lower tax rates, and eliminate deductions, exemptions, and credits, consistent with the tax principles.
4. Determine the fiscal impact of suggested changes at both the state and local level. Changes within a subcommittee do not need to be revenue neutral.

Tax Principles

- i. Equity – A tax system should be equitable and fair resulting in similarly situated tax payers being taxed similarly and similar transactions being taxed in the same manner.
- ii. Simplicity – A tax system should be as simple as possible, thereby reducing compliance burdens on taxpayers and administrative burdens on government.

- iii. Sufficiency – A tax system should provide the government with a sufficient and predictable source of revenue without having to resort to rate increases.
- iv. Efficiency – A tax system should be efficient and not impede or reduce the productive capacity of the economy.
- v. *Competitiveness – A tax system should be competitive with other states in order to promote long-term, sustainable economic development, job creation and growth.*

Note: Items in italics are amendments to the charge made by and agreed to by the subcommittee.

II. Issues dealt with over the last two months

- 1. Review and approval of the subcommittee's charge and related tax principles.
- 2. Tax revenue impact and other implications of moving to expanded tax bases and lower tax rates.
- 3. General understanding of the most recent tax reform activities in Ohio and Texas to include any "lessons learned".
- 4. Overview of the current taxing systems (corporate income and franchise, individual income and estate & gift), the existing weaknesses therein and possible solutions thereof.

III. Speakers providing information to the subcommittee and a summary of the presentations

Dr. Douglas A. Shackelford, Senior Associate Dean for Academic Affairs and Meade H. Willis Distinguished Professor of Taxation, Kenan-Flagler Business School, University of North Carolina – Dr. Shackelford provided the subcommittee with information surrounding Ohio's Commercial Activity Tax and Texas' Alternative Margins Tax.

Mr. Karl Smith, Graduate Fellow of the Institute for Emerging Issues and PhD Candidate in Economics at North Carolina State University – Mr. Smith provided an overview and demonstration of the "tax calculator" program which he developed. Additionally, he provided the subcommittee with an opportunity to propose different scenarios in order to determine the approximate impact on the various tax revenues.

Ms. Cindy Avrette, Staff Attorney, Research Division, North Carolina General Assembly – Ms. Avrette made a presentation with respect to North Carolina corporate income taxes. The presentation focused on the mechanics of the current tax system, its inherent weaknesses, prior attempts to repair its shortcomings, and possible solutions to include combined reporting.

Mr. Keith Davis, Senior Vice President and Director of State and Local Taxes, Bank of America Corporation – Mr. Davis discussed the advantages and disadvantages of combined reporting for corporate income tax purposes.

Mr. John Sharp, Chairman of the Texas Tax Reform Commission and former Texas Comptroller – Mr. Sharp discussed various aspects of Texas' recent tax reform (repeal of previous franchise tax and enactment of new alternative margins tax) to include "lessons learned".

Mr. Karey Barton, Tax Director of the Texas Tax Reform Commission and former Texas Director of Tax Policy – Mr. Barton also provided meaningful insights into Texas' recent tax reform.

Mr. Mike Hannah, Director, Multistate Tax Services, PricewaterhouseCoopers and former North Carolina Assistant Secretary of Revenue – Mr. Hannah provided the subcommittee with an overview of the current North Carolina corporation franchise tax and problems related thereto, information on prior legislative efforts to rectify some of the known problems and information on franchise taxes in other southeastern states.

Dr. Roby Sawyers, College of Management, North Carolina State University – Dr. Sawyers presented an overview of both the federal and North Carolina's current Estate and Gift tax system as well as what the future holds for these taxes based upon current law. Additionally, Dr. Sawyers provided the subcommittee with information on these tax systems in other states.

Dr. Dan Schisler, Chair, Department of Accounting, East Carolina University – Dr. Schisler discussed the advantages and disadvantages of using federal adjusted gross income ("AGI") as the tax base and a 5% flat tax rate for individual income tax purposes.

Mr. Karl Knapp, Director, Policy Analysis and Statistics Division, North Carolina Department of Revenue – Mr. Knapp provided the subcommittee with various individual income tax simulations. The simulations included various changes to the tax base, deductions, exemptions and tax rate.

IV. Specific recommendations (with a discussion of the reasoning and explanation for those recommendations)

Recommendation No. 1 – *Broaden the individual income tax base to federal AGI with minimal deductions and exemptions.* Broadening the tax base would allow the state to reduce the tax rate (see Recommendation No. 2) in order to provide more stability in this revenue source as well as to be more competitive with our southeastern states. Income from U.S. government obligations and *Bailey*-related retirement benefits would still be excluded from taxation. The subcommittee also recommends that appropriate measures be considered to ensure that the tax burden of lower-income taxpayers is not increased.

Recommendation No. 2 – *Reduce the top marginal individual income tax rate to a rate that is competitive with other southeastern states.* Other southeastern states have top marginal tax rates ranging from 5.75% to 7% and therefore, the subcommittee recommends that the state's top tax rate be reduced to approximately 6% (while maintaining some progressivity within the overall rate structure) in order to assist in promoting a competitive advantage for the state when competing for economic development opportunities.

Recommendation No. 3 - *Reduce the number of individual income taxpayers by eliminating the filing requirement of those with immaterial taxable income and who pay an insignificant amount of income tax.* The subcommittee noted a significant number of individual income taxpayers with immaterial taxable income and who pay an insignificant amount of income tax. Adhering to this recommendation would appear to significantly reduce the compliance burden of lower-income taxpayers and the Department of Revenue.

Recommendation No. 4 – *Broaden the corporate income tax base by repealing the existing separate entity reporting system and enacting a combined reporting regime for related entities.* Broadening the tax base promotes stability in the tax revenue (less volatile during weak economic conditions) and would allow for a reduction in the corporate income tax rate (see Recommendation No. 5). Combined reporting provides the broadest tax base than any other reporting system and therefore, would provide the most stable revenue base and the lowest tax rate. The subcommittee noted the lack of combined reporting in the southeast which might be viewed as a competitive disadvantage. However, the subcommittee believes that this perceived disadvantage would be partially mitigated when coupled with a reduction in the corporate tax rate.

Recommendation No. 5 – *Reduce the corporate income tax rate to a rate that is competitive with other southeastern states.* Other southeastern states have tax rates ranging from 5% to 6.5% and therefore, the subcommittee recommends that the state's rate be reduced to approximately 5.5%.

Recommendation No. 6 – *Conduct a comprehensive review of the corporate franchise tax in conjunction with Recommendation No. 4 in order to alleviate any possible compliance burdens as a result of two corporate tax reporting systems.* The subcommittee noted that if a combined reporting system was enacted for corporate income tax purposes, the state would then have two separate reporting systems applicable to corporate taxpayers (combined income and separate franchise). This could promote significant compliance burdens on corporate taxpayers and the Department of Revenue and consequently, the corporate franchise tax needs further review in conjunction with Recommendation No. 4.

Recommendation No. 7 – *Repeal the existing Estate and Gift Tax.* The subcommittee noted that North Carolina was only one of four states to impose a gift tax and that the revenues collected there from has historically been extremely small. Additionally, the subcommittee noted that North Carolina is one of only nineteen states who have an estate tax. Of the southeastern states, only North Carolina and Virginia have an estate tax (Virginia's is set to expire in 2007) which makes the state less competitive for retirees. The subcommittee recommends a repeal of both the estate and gift tax systems in order to become more competitive and to simplify the state's taxing system.

Recommendation No. 8 – *Reduce the state's reliance on the individual income tax.* The subcommittee noted that North Carolina relies more heavily on the individual income tax revenues than most other states. An income tax is generally viewed as being less stable than consumption-based taxes and therefore, less reliance thereto would provide a more predictable source of revenue for the state.

V. Issues yet to be reviewed by the subcommittee including a plan for addressing those issues

1. Allowable deductions and exemptions for individual income tax purposes – The subcommittee discussed whether deductions for social security benefits, mortgage interest and charitable contributions should be allowed from a broadened AGI tax base. Further review and analysis needs to be undertaken with respect to the implications of allowing some or all of the deductions. Additionally, there will be

tension between the allowable deductions and exemptions and the ability to lower the tax rate. Simply stated, an increase in allowable deductions and exemptions will result in a higher revenue-neutral tax rate.

2. Progressivity within the individual tax rate structure – The subcommittee concluded that some progressivity within the individual tax rate structure is necessary but the degree to which progressivity exists needs to be determined.
3. Threshold for requiring the filing of an individual income tax return – The subcommittee did not determine the threshold for requiring the filing of an individual income tax return. This subcommittee could address this issue in future deliberations if its life is extended beyond the current expiration date.
4. See Recommendation No. 6 – This subcommittee could conduct the review which it has recommended contingent upon its life being extended beyond the current expiration date.
5. Business credits & incentives – The subcommittee understands that a new committee has been constituted whose charge is to review these issues. In light of this new development, the subcommittee agreed not to review these items but rather to defer to this new committee.

VI. Other matters that you would like to bring before the full commission

None.